

When it comes to savings, interest is what it's all about. Interest is what a borrower pays a lender for the use of the lender's money.

When you deposit money in a savings account, a money market account, an interest-bearing checking account or a certificate of deposit (CD), you're lending that financial institution your money. The institution uses that money to make loans — essentially, borrowing money from you and paying you interest for the right to use your money to lend to someone else.

Of course, the institution then charges that loan customer an even higher interest rate to more than recover the interest it's paying you. Interest is calculated as a percentage of the amount of the loan. Interest can get complicated, especially when the terms "rate" and "yield" are involved.

You may see a \$10,000 CD with a 5-percent annual interest rate (APR), but right next to it is the annual percentage yield (APY) number and it's higher.

**The difference between rate and yield is determined by how frequently interest is paid, and how it is paid.**

Rate is the nominal, or stated, interest rate on the investment. If you have a CD with a 5-percent nominal rate, then interest is calculated by multiplying 5 percent by the amount invested and by the fraction of a year the money is invested.

Let's say interest pays annually. A \$10,000 investment will earn \$500 in interest. ( $\$10,000 \times 5 \text{ percent} \times 1 \text{ year}$ .) When an investment pays interest annually, its rate and its yield are the same.

The more frequently interest is paid, the higher the yield. That's because the interest payment is credited to the CD and it starts earning interest along with the invested principal.

If the 5 percent CD paid interest semi-annually, the six-month interest payment would be \$250, ( $\$10,000 \times 5 \text{ percent} \times .5 \text{ years}$ .)

The \$250 payment starts earning interest and earns \$6.25 in interest during the next six months, ( $\$250 \times 5 \text{ percent} \times .5 \text{ years}$ .) That's what compounding interest is all about.

The first CD earned \$500 in interest after a year and the second CD earned \$506.25 in interest. The rate and yield on the first CD is 5 percent. The rate on the second CD is 5 percent, but its yield (APY) is 5.06 percent. If interest was paid daily, the rate would be 5 percent but the yield (APY) would be 5.13 percent.

These yield computations assume that the interest is reinvested in the CD at the CD's nominal rate.

**Always shop for the best Annual Percentage Yield.**

## How Interest Rates are Determined

Interest rates are affected by a number of factors. The Federal Reserve, which is charged with maintaining the stability of the nation's financial system, raises or lowers short-term interest rates in an effort to maintain that stability.

The Fed regularly takes these actions in response to economic expansions and contractions that the country goes through on a fairly routine basis. Short-term rates are raised in expansions — good times — to keep the economy from building too fast and risking inflation, which is caused by too much money chasing too few goods and services. Raising rates makes it more expensive for companies and individuals to borrow money.

The Fed will lower short-term rates when the economy is contracting — slowing down. Lowering rates makes it less expensive to borrow money, the idea being that businesses and consumers will buy more products and services and speed the economy up a bit and keep the economy from sinking into a recession.

A recession happens when consumers hold on to their money and don't buy the products and services that keep companies afloat and employees employed.

When the Fed cuts short-term rates, it is cutting the rate that banks charge each other to borrow money. Those cuts are

eventually passed on to businesses and consumers. The same thing happens in reverse when the Fed raises short-term rates.

Other factors affect interest rates, too, but on a more irregular basis. A crisis involving the foreign oil-producing nations, for example, could have a major economic impact that could affect interest rates.

Long-term interest rates aren't affected by economic conditions as much as short-term rates, but there is a trickle down factor and they reflect the impact eventually.

What works for you, as a saver, works against you as a borrower. When rates are high, you're earning a hefty amount of interest for your deposits, but you're going to pay a high interest rate if you need to borrow.

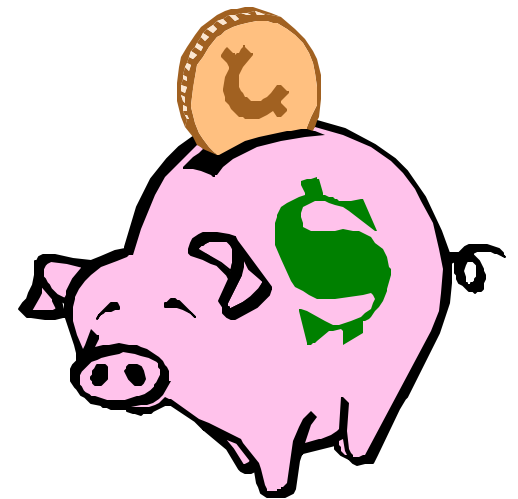
**When rates fall, you don't get much interest on your savings, but it's a lot cheaper to borrow money.**

Call our toll-free number or write to the address on the cover for a copy of any of the brochures or for further consumer credit information. You can also access information at our web site on the Internet: <http://www.dfi.state.in.us>, then click on Consumer Credit.



# SAVINGS BASICS

## Understanding Savings



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